

# **“Outsourcing California: Our Jobs and Privacy at Risk”**

**A Joint Hearing of the  
Senate Business and Professions Committee  
and the  
Senate Select Committee on International  
Trade Policy and State Legislation**

**Chair, Senator Liz Figueroa**

**Tuesday, March 9, 2004  
State Capitol, Room 4203  
California Room  
Sacramento, California**

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\*Individual testimony of Witnesses and copies of press articles listed on agenda available upon request from the Senate Business and Professions Committee at 916-445-3435 or email [Kathleen.Sullivan@sen.ca.gov](mailto:Kathleen.Sullivan@sen.ca.gov)

\*\*Video of Hearing available by calling 916-445-4913 (3 tapes at a cost of \$15 plus \$5.00 shipping)

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## **“Outsourcing California: Our Jobs and Privacy at Risk”**

**A Joint Hearing of the Senate Business and Professions Committee and  
the Senate Select Committee on International Trade Policy and State Legislation**

### **Agenda**

**Tuesday, March 9, 2004  
State Capitol, Room 4203  
Sacramento, California  
9:00 a.m. - 2:00 p.m.**

### **Opening Remarks:**

**Senator Liz Figueroa, Chair  
Committee Members**

**Video Presentation: “Out of India,” by 60 Minutes (Time: 12 minutes)**

### **The Trend Towards Outsourcing**

**Cynthia Kroll, Senior Regional Economist, Fisher Center for Real Estate and  
Urban Economics, UC Berkeley Haas School of Business**

**Justin Marks, National Conference of State Legislators**

**Jeff Lande, Senior VP, IT Services Division, Information Technology Association of America**

**Dominic Di Mare, California Chamber of Commerce**

**Angie Wei, Legislative Advocate, California Labor Federation**

**Natasha Humphries, Displaced Worker**

**Ellen Shaffer, Director, Center for Policy Analysis on Trade and Health**

## **Is the State Outsourcing Government Contracts?**

**Jim Schneider**, *Consultant, State Controllers Office*

**Doug Hoffner**, *Assistant Director – Legislation, Department of General Services*

**Bruce Wagstaff**, *Deputy Director for Welfare to Work Division, Dept. of Social Services*

**Lyle Hintz**, *Chair of the Contracting Out Committee, SEIU Local 1000*

## **Medical Privacy**

**Clifton Louie**, *Associate Director for Clinical Services, UCSF Medical Center*

**Faith Raider**, *Policy Analyst, AFSCME Local 3299*

**LaVonne La Moureaux**, *Executive Director, California Health Information Association*

**Amy Buckmaster**, *Immediate Past President, American Association for Medical Transcription*

**Sean Carroll**, *President of the Medical Transcription Industry Alliance*

**Steve Mandell**, *CEO and President, Heartland Information Systems, Inc.*

**Roseanne Sullivan**, *Consultant with MTStars*

**Astrid Meghrigian**, *Associate Director, California Medical Association Government Relations*

## **Financial Privacy**

### **Panel 1:**

**Lenny Goldberg**, *Legislative Advocate, Privacy Rights Clearinghouse*

**Chris Larson**, *Chairman & CEO, E-LOAN, Inc.*

**David Wyle**, *CEO, SurePrep, LLC*

**Larry Ponemon**, *Chairman, Ponemon Institute, LLC*

### **Panel 2:**

**Mike Ueltzen**, *Chair, Government Relations Committee, California Society of CPA's*

**Richard Robinson**, *Legislative Advocate, Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers (did not appear)*

**Ronald Blanc**, *Chair, Committee on Professional Conduct, California Board of Accountancy*

**Art Kroeger**, *Society of California Accountants*

**Walt Thomas**, *Legislative Chair, California Tax Education Council*

**Kim Kastl**, *California Society of Enrolled Agents*

**Marcia Fritz**, *CPA*

## **Public Comment Period**

## **Closing Remarks**

**Senator Liz Figueroa**, *Chair*

**Committee Members**

## Press Articles

'Offshoring' Trend Casting a Wider Net, Marla Dickerson, L.A. Times, 1/4/2004

Lawmakers work to limit cheaper overseas labor, Contra Costa Times, 1/12/2004

Pakistani threatened UCSF to get paid, she says, David Lazarus, San Francisco Chronicle,  
11/12/2003

The user has a right to know, David Lazarus, San Francisco Chronicle, 11/9/2003

Credit agencies sending your files abroad, David Lazarus, San Francisco , Chronicle, 11/7/2003

A politician who reads the papers, David Lazarus, San Francisco Chronicle, 10/26/2003

A tough lesson on medical privacy, David Lazarus, San Francisco Chronicle, 10/22/2003

Tech bosses defend overseas hiring, David Lawarus, San Francisco Chronicle, 1/8/2004

Bills aim to slow overseas job flow, Clint Swett, Sacramento Bee, 2/17/2004

Secrecy the word on outsourcing, Karl Schoenberger, Mercury News, 2/16/2004

Debate Over Offshoring: Echoes of Privacy Fight, Robert Julavits, American Banker, 2/13/2004

Sharing of info gets attention, David Lazarus, San Francisco Chronicle, 2/29/2004

Appraisals being sent abroad, David Lazarus, San Francisco Gate, 2/6/2004

Privacy takes a backseat, David Lazarus, San Francisco Chronicle, 10/24/2003

When tax returns go overseas, David Lazarus, San Francisco Chronicle, 12/17/2003

Small and Smaller, Thomas L. Friedman, New York Times, 3/4/2004

Newest outsourcing wave: Foreign accountants prepare Americans' tax returns, San Diego Daily  
Transcript, 2/24/2004

Outsourcing Tax Prep is In, In, In – American Institute of Certified Public Accountants,  
June 2003

Offshoring's giant target: the Bay Area-Silicon Valley could face export of 1 in 6 jobs – worst in  
nation – S.F. Chronicle, by Carrie Kirby and John Sinal

*Institute of Business and Economic Research*  
Fisher Center for Real Estate &  
Urban Economics  
(University of California, Berkeley)

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Fisher Center Research Reports  
The New Wave of Outsourcing

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# Research Report

Fisher Center for Real Estate and Urban Economics · University of California, Berkeley · Fall 2003

## The New Wave of Outsourcing

Ashok Deo Bardhan and Cynthia A. Kroll

There is growing apprehension among business leaders, economists, and ordinary Americans that we are witnessing what may well be the largest out-migration of nonmanufacturing jobs in the history of the US economy. This concern has been fueled by newspaper reports and economic news highlighting the layoffs of thousands of people in high-tech, software and service sector companies in the US, and the practically simultaneous, seemingly coordinated establishment of offices and development centers, most often in India, resulting in hiring of thousands of new employees in that country. For example, tabulation by the authors of reports in Indian newspapers and business journals for the month of July 2003 alone gave an estimate of 25,000 to 30,000 new outsourcing related jobs announced by US firms. In the same month, there were 2087 mass layoff actions carried out by US employers resulting in a loss of 226,435 jobs.<sup>1</sup> The jobs being created in India and elsewhere are in a wide range of services sectors such as geographic information systems services for insurance companies, stock market research for financial firms, medical transcription services, legal online database research, and data analysis for consulting firms, in addition to customer service call centers,

payroll and other back-office related activities.

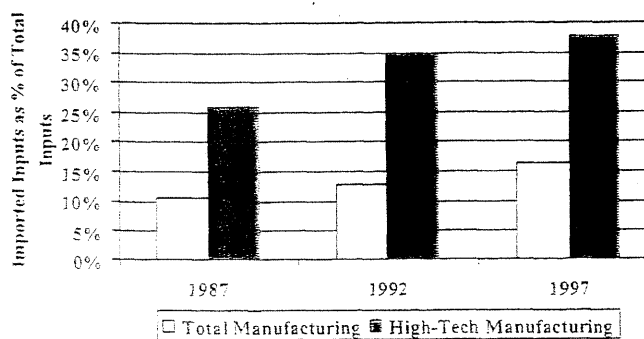
In this short overview we address the following questions: Have jobs been transplanted from the US? How significant is this phenomenon and how sustainable is it? What is the potential impact on future job creation and wage inequality in the US? How is it likely to impact the real estate sector?

### The First Wave: Outsourcing of Manufacturing

Between 1987 and 1997, the share of imports in inputs used in US manufacturing increased from 10.5% to 16.2% and in high-tech manufacturing, such as computers and electronics, from 26

to 38% (See Figure 1). These data continue a long history of foreign outsourcing in US manufacturing and the associated loss of blue-collar jobs in many industrial sectors. Indeed, one of the attributes of the modern stage of globalization for advanced industrialized countries is the offshore production of intermediate inputs, usually in low-cost developing countries. The motivation, on the part of US firms, has been driven by the low costs of manufacturing abroad, primarily in the East Asian countries, such as Taiwan, China, South Korea, Malaysia and others, as well as the availability of skilled labor, the promotion of a business-friendly environment and the existence of production and supply

Figure 1  
Imported Inputs as a Share of Total Inputs  
Total Manufacturing and High-Tech Sectors



Source: Bardhan, Jaffee and Kroll, *Globalization and a High-Tech Economy*, forthcoming.

<sup>1</sup>Bureau of Labor Statistics.

networks in those countries. At the same time, the higher value-added, better paying jobs in management, finance, marketing, research and development have been retained in the home country.

Considerable research has been carried out on the phenomenon of outsourcing in manufacturing and many of the economic insights and conclusions are applicable to Business Process/Services Outsourcing (BPO/BSO) as well. As pointed out by Bardhan, Jaffee and Kroll in their forthcoming book, *Globalization and a High-Tech Economy*, the outsourcing of parts of the supply chain of manufacturing has resulted in a shift of demand, and hence jobs, from blue-collar to white-collar and from manufacturing to services, increased wage inequality between blue-collar and white-collar jobs, and increased profitability of US firms. They also note that recessionary downturns seem to prod firms into making major restructuring moves, and that a recession might be the mother of innovation and dynamism.<sup>2</sup>

### **The New Wave: Outsourcing of White Collar Jobs**

The software sector was the first service sector to transfer significant activity to foreign locations, leading to the creation of a critical mass of expertise and resources in concentrated locales, such as the city of Bangalore in India. The rapid dissemination of the Internet, the transnational networks set up by immigrants in the US, and liberalization of emerging market

economies created the conditions for a major burst of outsourcing in the 1990s, in hitherto primarily domestic segments of non-manufacturing sectors, such as telecommunications, retail trade, and finance (including banking and insurance). While the "push" factors for business process outsourcing (BPO) or business services outsourcing (BSO) are similar to those for manufacturing and are largely cost-driven, the "pull" factors and attributes of countries and economies providing outsourced services are somewhat different. In addition to cost advantages similar to those offered by the manufacturing centers of East Asia, the ongoing outsourcing of business services jobs to India, Malaysia, Philippines and South Africa among others is also due to the widespread acceptance of English as a medium of education, business and communication in these countries; a common accounting and legal system (at least in some of the countries), the latter based on the common law structure of UK and US; general institutional compatibility and adaptability; the time-differential determined by geographical location leading to a 24/7 capability and overnight turnaround time; simpler logistics than in manufacturing, and a steady and copious supply of technically savvy graduates.

India's information technology enabled services (ITES) sector, the primary destination of business services outsourcing from Western countries, now directly employs over 200,000 people with around \$2.3 billion in exports, of which over 70% are to the US. While the sector is still small it is growing at a rate of 60% per annum. The software services sector overall has exports of approximately \$9.5 billion, of which over \$7 billion are to

the US<sup>3</sup>. India's National Association of Software and Service Companies (NASSCOM), the primary trade organization of all IT related firms, forecasts that exports would hit the \$50 billion mark in the next five years. By that time, the business process/business services outsourcing segment would employ over 2 million people, and the total exports of the IT industry would support over 8 million jobs.

The growth of the IT sector in general and the BPO segment in particular is not confined to India. Firms involved with software services outsourcing and BPO are rapidly gaining ground in the Philippines and Malaysia (call centers and other back-office BPO), China (embedded software, financial firm back-office BPO, some application development), Russia and Israel (high-end customized software and expert systems), and Ireland (packaged software and product development). While it is difficult to estimate the exact number of jobs created in these countries in these sectors, let alone those transplanted and created by US firms, tentative evidence collected by the authors suggests that business process outsourcing and software outsourcing have together generated, at the very least, over a million jobs in the 1990s and hundreds of thousands more since the turn of the century.

### **BPO/BSO Impact on the US Economy**

The second half of the 1990s was a time of high employment and robust growth for the software-related sectors, as well as the services sector at large. The job creation from outsourcing in countries around the world dur-

<sup>2</sup> Most economists believe, however, that outsourcing should not lead to job loss in the long run but to a reshuffling of jobs and a new composition of occupations in the economy. This recovery of jobs lost to outsourcing still requires major changes in the industrial and employment structure of the economy.

<sup>3</sup> National Association of Software and Service Companies, India, at [www.nasscom.org](http://www.nasscom.org).

ing this period can be seen as spin-offs from the US because of tight labor markets, rather than job transfers out of the US in search of lower labor costs. However, the recent downturn and the continuing jobless recovery have legitimately given rise to the question whether services outsourcing involves the transfer of US jobs and occupations to other countries. Table 1 shows employment data for those

sectors of the economy that felt a disproportionate impact of outsourcing. These include the computers and electronic products manufacturing sector (including its sub-sector, semiconductors and electronic components); professional and business services sectors such as business support services, which include call centers, and computer systems design services; and information industries such as tele-

communications, software publishing, and Internet services providers. Between first quarter 2001 and second quarter 2003, i.e. in the course of just over 2 years, the employment in these sectors has plummeted by 15.5% in the US as a whole, and 21% in the state of California, corresponding to a job loss of over 1 million and 200,000 respectively in these sectors alone.

**Table 1**  
**Employment Change in Industries At Risk to Outsourcing\***

Industry Name	US Employment (Thousands)			California Employment (Thousands)		
	Q1-2001	Q2-2003	% Change 2001-2003	Q1-2001	Q2-2003	% Change 2001-2003
<i>Nonmanufacturing Sectors</i>						
Software Publishers (except Internet)	276.1	247.9	-10.2%	55.8	47.1	-15.6%
Internet Publishing and Broadcasting	50.6	33.7	-33.4%			
Telecommunications	1323.4	1138.9	-13.9%	150.5	123.5	-18.0%
ISPs, Search Portals, and Data Processing	516.0	433.2	-16.0%	60.2	48.0	-20.2
Data Processing and Rel. Services	320.9	292.2	-8.9%	24.4	18.9	-22.8%
Accounting, Bookkeeping & Payroll	976.3	875.7	-10.3%	108.8	103.1	-5.2%
Payroll Services	158.9	124.6	-21.6%			
Computer Systems Design and Rel.	1341.2	1148.1	-14.4%	218.2	163.2	-25.2%
Business Support Services	784.4	746.2	-4.9%	56.2	57.2	1.7%
Telephone Call Centers	406.2	363.2	-10.6%			
Telephone Answering Services	54.8	50.9	-7.1%			
Telemarketing Bureaus	351.4	312.3	-11.1%			
<i>Manufacturing Sectors</i>						
Computer and Electronic Products	1862.1	1415.9	-24.0%	443.1	336.8	-24.0%
Semiconductors and Electronic Components	308.7	237.9	-22.9%	162.1	115.2	-29.0%
Subtotal: At-Risk Industries	6853.9	5791.8	-15.5%	980.8	774.6	-21.0%
All Nonfarm	131,073.0	130,515.3	-0.4%	14,608.2	14,491.8	-0.8%
Manufacturing	16,932.3	14,757.7	-12.8%	1,849.0	1,587.2	-14.2%
Nonmanufacturing	114,141.3	115,757.7	1.4%	12,759.2	12,904.6	1.1%

\* The authors have chosen those industries which, in our judgment, have been most often noted as outsourcing to India and East Asia. These industries have a substantial share of the occupations discussed in the next section.  
Source: Authors from US Bureau of Labor Statistics data.

**Figure 2**  
**Attributes of Jobs Outsourced**

- No Face-to-Face Customer Servicing Requirement
- High Information Content
- Work Process is Telecommutable and Internet Enabled
- High Wage Differential with Similar Occupation in Destination Country
- Low Setup Barriers
- Low Social Networking Requirement

**Table 2**  
**Average Salaries of Programmers**

Country	Salary Range
Poland and Hungary	\$4,800 to \$8,000
India	\$5,880 to \$11,000
Philippines	\$6,564
Malaysia	\$7,200
Russian Federation	\$5,000 to \$7,500
China	\$8,952
Canada	\$28,174
Ireland	\$23,000 to \$34,000
Israel	\$15,000 to \$38,000
USA	\$60,000 to \$80,000

Source: *CIO* magazine, November 2002, Smart Access Survey, Merrill Lynch.

Indisputably, most of the job loss is due to the technology downturn, the dot-com bubble, and the cyclical downturn in the US economy. However, outsourcing that began as a response to very tight labor markets in the US in 1999-2000 has continued, becoming a factor in the "jobless" or "job-loss" recovery of 2003. As in the last downturn in the early nineties, recession-based cost-cutting by firms may end up as the permanent loss of jobs that remain abroad even during the subsequent recovery. The laid-off US workers must then be absorbed either in new sub-sectors, brought about by innovation, or in other lesser-paying, non-tradable services jobs.

Vulnerability to outsourcing extends well beyond the sectors shown in Table 1. The employment services sector, for example, lost over 300,000 jobs between June 2000 and January 2001 and over 150,000 between January 2001 and June 2003 (again a mix of recession-based losses and outsourcing). Links to outsourcing in this sector come through temporary employee agencies, which provided short-term employees to many of the industries listed in Table 1. Outsourc-

ing also has the potential to affect diverse segments of retail and wholesale trade, utilities and healthcare, to the extent that record-keeping, accounting, sales, and information aspects of these sectors can be performed separately from other functions.

### **Outlook for Services Outsourcing**

The occupational mix of a sector may determine its vulnerability. In BPO/BSO circles it is said half-seriously that any job that involves mostly "...sitting at a desk, talking on the phone and working on a computer..." is a job under potential threat. Figure 2 summarizes the essential attributes and features of jobs and occupations that might find themselves in jeopardy.

While institutional and cultural compatibility and proliferation of the English language are key components of comparative advantage for countries that are destinations for BPO investment and activity, it is the cost differential, along with the availability of well-educated graduates, that provides the critical competitive edge. As Table 2 shows, the salaries of computer

programmers in the emerging market countries of Asia and Eastern Europe are a factor of ten less than corresponding salaries in the US. The cost-differential in BSO is more difficult to pin down, since the range of occupations is so wide. Table 3 shows hourly wages for some sample occupations from the July 2002 National Compensation Survey of the Bureau of Labor Statistics matched with comparable occupations in India. The wage differential varies widely by occupation, with differences particularly high for lower wage, nonprofessional occupations and less extreme, although still quite significant, at the upper end of the wage spectrum.

A lower wage scale is even more attractive if it comes with a well educated labor force. The three major emerging market economies—China, India, and Russia—have a sizeable higher education sector. While Russian expertise in many basic sciences and engineering subjects has been justly famous for decades, both the annual output and quality of science

**Table 3**  
**Hourly Wages for Selected Occupations**  
**US and India, 2002/2003**

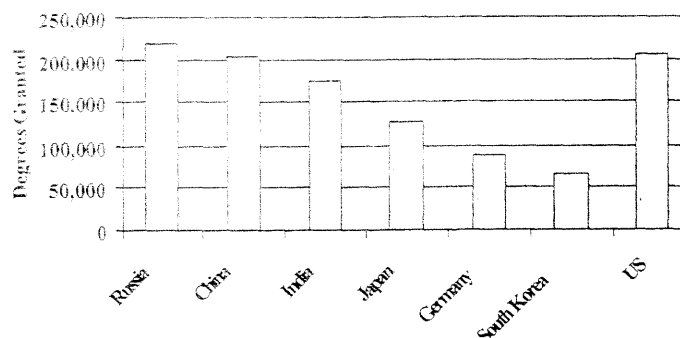
Occupation	Hourly Wage, US	Hourly Wage, India
Telephone Operator	\$12.57	Under \$1.00
Health Record Technologists/Medical Transcriptionists	\$13.17	\$1.50-\$2.00
Payroll Clerk	\$15.17	\$1.50-\$2.00
Legal Assistant/Paralegal	\$17.86	\$6.00-\$8.00
Accountant	\$23.35	\$6.00-\$15.00
Financial Researcher/Analyst	\$33.00-\$35.00	\$6.00-\$15.00

Source: US wages are from US Bureau of Labor Statistics, National Compensation Survey, July 2002; India wages are from interviews, business literature search and review of employment Want Ads by the authors.

and engineering graduates from India and China have been increasing rapidly and are now comparable to the advanced countries<sup>4</sup> (see Figure 3). These countries face some constraints in exploiting this ongoing opportunity. India's inability to provide education at the basic school level could stifle further growth in highly trained graduates. Russia faces growth constraints from a combination of institu-

<sup>4</sup> The figure for the US includes graduates who are foreign citizens. However, the proportion of foreign citizens is considerable only at the PhD and MS level, not so much at the basic undergraduate level of higher education.

**Figure 3**  
**Yearly Graduates with Natural Science and Engineering Degrees 1998**



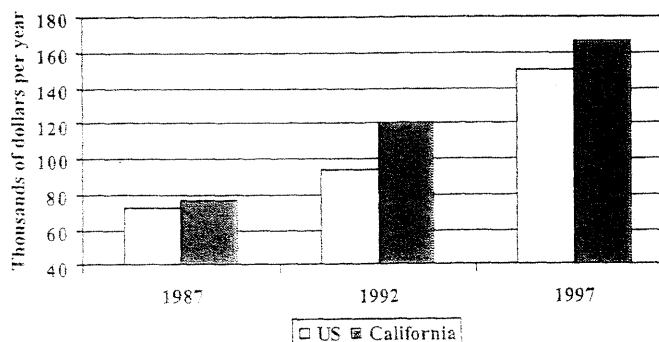
Source: National Science Foundation (Science and Engineering Indicators, 1998).  
Note: Figures are by country where degree granted and may include foreign nationals.

tional underdevelopment, erratic reforms and the gradual deterioration of the higher education system. The overpowering Chinese success in manufacturing may well be replicated later in the services sectors, but as yet business services outsourcing faces heavy language, institutional and cultural barriers. Rising wages and costs in these countries may spur secondary outsourcing to still less

developed countries, but from the point of view of the US labor markets that is no consolation.

Despite these barriers, the phenomenon of services outsourcing is sustainable for the foreseeable future, unless there is a major disruption of the international economy or a severe backlash in the developed countries leading to establishment of regulatory

**Figure 4**  
**US and California High-Tech Manufacturing Sectors**  
**Annual Value-Addition Per Employee**



Source: Bardhan, Jaffee and Kroll, *Globalization and a High-Tech Economy*, forthcoming.

hurdles. The benefits to US firms are the increased value addition and profitability resulting from savings due to low-cost outsourcing. Figure 4 shows the constant increase in value-addition per employee in high-tech manufacturing from 1987 to 1997, a period of intense outsourcing activity in manufacturing overall. The impact of the present cycle of BPO/BSO is perhaps reflected as well in the latest productivity figures released by the US Bureau of Labor Statistics: Nonfarm business output per hour worked increased by 5.4% in 2002, and by a sizeable 6.8% in the second quarter of 2003.

#### Outlook for US Jobs and Occupations

If both the supply and the demand side suggest a sustainable outlook for business services outsourcing, it is imperative to get at least a heuristic

sense of the potential size of the long term impact on jobs and occupations. The authors have tried to arrive at an estimate of the outer limit of jobs potentially at risk to outsourcing by adopting the following methodology:

- a) We focus not on economic and industrial sectors, as in Table 1, but rather on the occupational make-up of the US economy, given by the detailed Occupational Employment Statistics, 2001, published by the US Bureau of Labor Statistics.
- b) We are guided by the occupational "outsourcability attributes" listed in Figure 2.
- c) We only take into account those occupations where at least some outsourcing has already taken place or is being planned, according to business literature.

There are 22 broad occupational classifications listed by the Bureau of Labor Statistics.<sup>5</sup> Within these 22 broad categories there are 770 detailed occupations. Table 4 shows the aggregate and detailed occupations which we judge to be consistent with the criteria a, b and c listed above. Of course not all jobs are under threat in any of these categories. Table 4 lists the *outer limit* of potential direct job loss in these occupations, without taking into account many of the dynamic adjustments that may take place or changes that may occur in qualifications, skill requirements and task descriptions.

Data on these occupations are available for 2001 and some earlier years. The data indicate that these jobs span a wide range of compensation levels, from salaries one-third below the average to almost twice the average salary. In some outsourceable occupations, job growth was strong at least through 2000, but the occupations most vulnerable to outsourcing began losing jobs. For example, data entry positions dropped by 115,000, or 22%, between 1999 and 2001, even though employment in computer occupations as a whole was increasing. As occurred earlier in manufacturing, it was the lower paying, more routine jobs that were being outsourced most rapidly. This is consistent with the particularly wide wage differentials found in the lower paying occupations.

**Table 4**  
**US Employment in Occupations at Risk to Outsourcing**

Sectors	Employment 2001	Average Annual Salary 2001
All Occupations (Total US Employment)	127,980,410	\$ 34,020
<i>Occupations at Risk of Outsourcing</i>		
Office Support*	8,637,900	\$ 29,791
Computer Operators	177,990	\$ 30,780
Data Entry Keyers	405,000	\$ 22,740
Business and Financial Support**	2,153,480	\$ 52,559
Computer and Math Professionals	2,825,870	\$ 60,350
Paralegals and Legal Assistants	183,550	\$ 39,220
Diagnostic Support Services	168,240	\$ 38,860
Medical Transcriptionists	94,090	\$ 27,020
Total in Outsourcing Risk Occupations	14,063,130	\$ 39,631
Percent of All Occupations	11.0%	

Source: Authors using data from Bureau of Labor Statistics web site. \*Office support aggregates data from 22 detailed Office and Administrative Support categories. \*\* Business and financial support aggregates data from 10 detailed Business and Financial Occupations. Further details on sectors available from the authors.

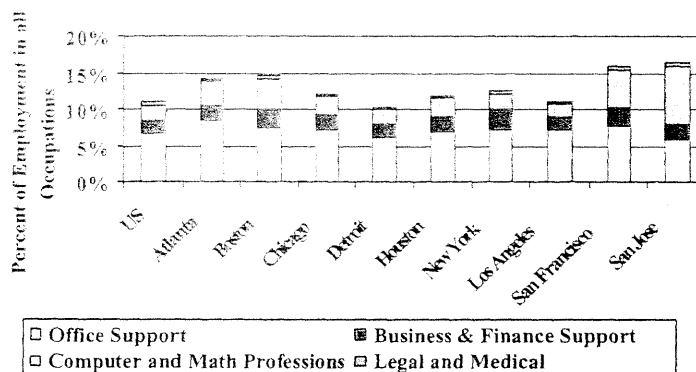
<sup>5</sup> Many categories of these broad occupational classifications, such as "personal care and service" occupations, "food preparation and serving related" occupations, construction, repair and maintenance related occupations, community and social service occupations and others are obviously "non-outsourceable".

There have been many different estimates of potential job losses in the US from future business services outsourcing. A report by Forrester Research forecasts that by the year 2015, approximately 3.3 million jobs will have been irretrievably lost, almost one fourth of our estimate of total employment in outsourcing occupations at risk in 2001. This translates to a little over 250,000 per year, a number which seems conservative, based on the rate of outsourcing over the last few years, the experience of outsourcing in manufacturing, the increasing ability of an increasing number of countries to compete for these jobs, the higher tradability of services due to better communications, increasing use of English and US standards in business and commerce, and the obvious benefits to US firms and employers, the primary decision-makers in this process. This outsourcing of jobs could result either in net job loss in some occupations and sectors or in a slower pace of job expansion than would otherwise occur.

### Outsourcing Has Regional Implications

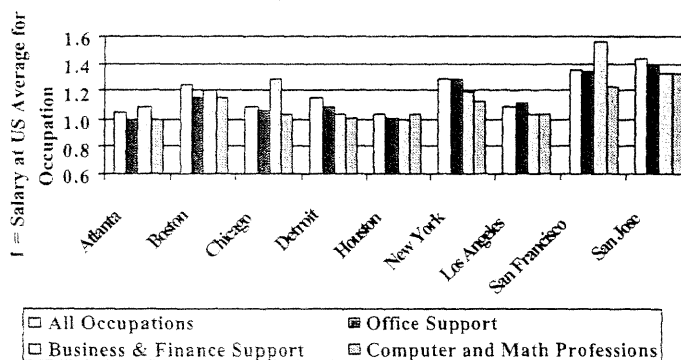
As with manufacturing outsourcing, the process of services outsourcing is likely to vary geographically, among different regions of the US and within metropolitan areas. Figure 5 shows occupations at risk for some of the largest metropolitan areas in the US, while Figure 6 shows wage levels by occupation, relative to the US, for the same metropolitan areas. Most of the nation's large metropolitan areas have a higher proportion of jobs in occupations at risk than is found in the US as a whole, suggesting that many of these urban centers may share disproportionately in the wave of outsourcing. However, the occupational composition of the at-risk jobs varies widely among these MSAs, as do wage levels, and the type of job re

**Figure 5**  
Occupations at Risk to Outsourcing as a Share of Employment in All Occupations  
Selected US MSAs



Source: Authors from Bureau of Labor Statistics data.

**Figure 6**  
Salaries in Occupations at Risk of Outsourcing Relative to Average US Salaries in At-Risk Occupations  
2001, Selected MSAs



Source: Authors from Bureau of Labor Statistics data.

shuffling is likely to reflect these differences. Detroit has lower than average shares of services jobs at risk to outsourcing and may share less in the impacts of this round of outsourcing (but has no doubt suffered from manufacturing outsourcing in earlier years). Atlanta has a high share of

office support occupations, at average wage levels. Possibly an earlier recipient of jobs spun off from more costly metropolitan areas, places like Atlanta may be at risk of losing more of their lower-wage outsourceable jobs, although it could also continue to be the recipient of jobs outsourced

domestically from higher-wage areas. Within California, there is a wide variation among places. Los Angeles, with less than average shares of most services sectors at risk to outsourcing and close to average salaries within these sectors, may have less to lose from the next wave of outsourcing than high priced markets elsewhere in the state.

High-tech markets such as San Jose, San Francisco and Boston are particularly at risk of services outsourcing over the next decade. San Jose, the heart of Silicon Valley, has below average shares of outsourceable office support and business and financial support occupations, but almost four times the average share of computer and math jobs (relative to its total share of US employment). At salary levels well above the US average, the region has already lost many of the lower-wage occupations to other parts of the country or abroad. Its vulnerability now lies in the very high share of high-wage outsourceable professional occupations, many of which are similar to the types of positions growing in the lower cost foreign locations described earlier. Businesses that forged a relationship with an overseas supplier at the height of the dot-com boom may continue to take advantage of the cost savings, despite the dot-com collapse and easing of demand for these occupations in US locations.

Outsourcing has intraregional implications as well, especially in the more moderately priced urban areas. Some

of the largest overseas migrations of services jobs have been in occupational categories that were once the core of suburban job development, such as data processing and call centers. Suburban locations that built up an employment base of back office jobs could see these tenants shrink, or expansion opportunities evaporate, as these occupations shift overseas.

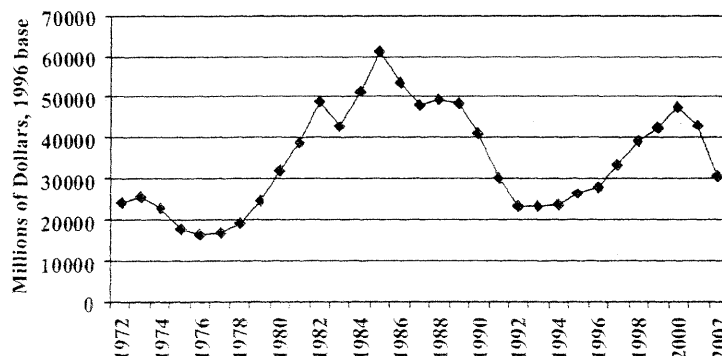
### Present and Future Impact on Office Markets

The office building sector faces considerable uncertainty going forward. CB Richard Ellis reports that close to 17% of for-lease US office space is vacant. Rosen Consulting Group (RCG) figures show at least 700 million square feet are vacant in the office-leasing market of major US metropolitan areas. Building activity in the late 1990s, although more constrained than in the late 1980s, was

still the highest in a decade, as shown in Figure 7.

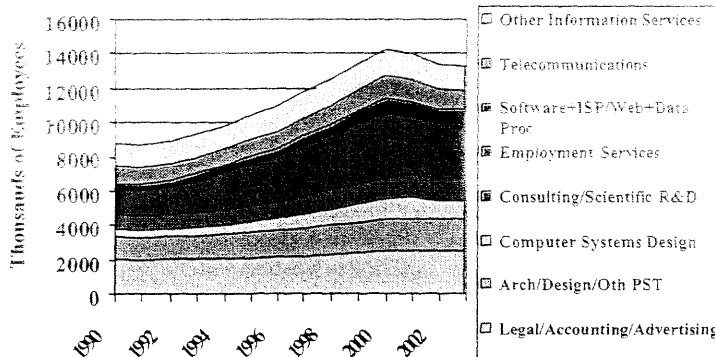
Because office construction tends to involve years of preparatory planning, much of the new space came on line just as the dot-com bubble collapsed and employment in office-related sectors began to shrink. Employment in key office sectors, on a national level, has dropped by 6.5% in the US and by almost 10% in California since its peak in 2000, in both cases returning to between 1998 and 1999 levels, as illustrated in Figure 8. The most vulnerable sectors have been computer-related industries, telecommunications, and employment services—the temporary employment services that helped fuel the technology expansion. Many of these are the same sectors now undergoing extensive outsourcing.

**Figure 7**  
**Annual Value of Office Construction in Place**  
**Constant Dollars, 1972-2002**



Source: US Bureau of the Census.

**Figure 8**  
Employment Trends in Selected Information, Professional  
and Business Services Sectors, US

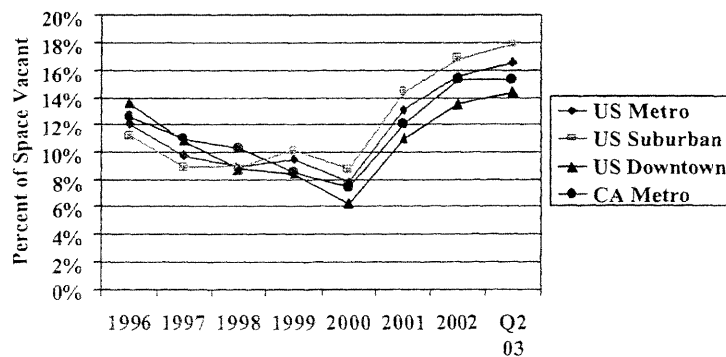


Source: Authors from Bureau of Labor Statistics data.

Office vacancy rates responded quickly to the combination of declining employment and new space coming on line. Nationwide, rates doubled, from below 8% in December 2000 to over 16% in June 2003, as shown in Figure 9. In California, vacancies rose to an estimated 15.3%, ranging from below 10% in Sacramento to above 20% in Silicon Valley markets.

Two factors are at work when vacancy rates rise—changes in the amount of space occupied and changes in the total amount of space available. Figure 10 shows occupied and vacant space nationwide since 1991, as distributed in downtown and suburban markets (the four segments of each bar add up to total square footage). Despite job losses due to a range of factors, the decrease in square footage under lease (i.e. occupied) in suburbs and downtown areas combined has been modest—about 4% since 2000. The rest of the rise in vacancy comes from a 6.6% increase in supply, which may come from new

**Figure 9**  
US and California Office Vacancy Rates, 1996-2003



Source: US data is from CB Richard Ellis. California data is from the authors, as compiled from data from CB Richard Ellis, Cushman and Wakefield, Grubb and Ellis, and Keegan and Coppin. Except for 2003, all years are for 4<sup>th</sup> quarter.

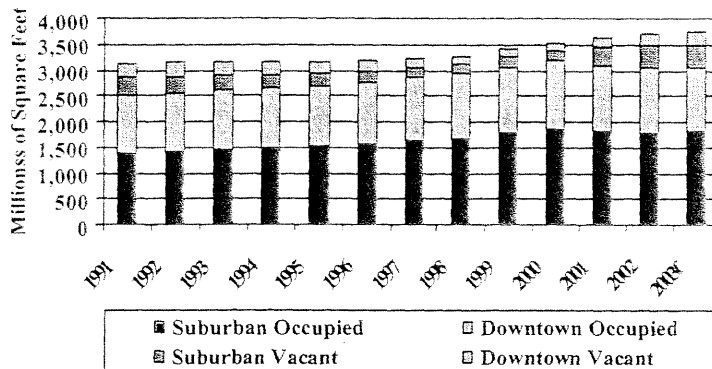
construction or from existing buildings entering the for-lease market (for example, owner occupied buildings made available for lease). This second element of supply increase may account for the difference between the percent change in office employment and the percent drop in space under lease. The new for-lease space added

to the total stock from owner-occupied buildings becoming for-lease buildings is actually a further sign of declining demand.

Figures 9 and 10 also highlight a shift that is occurring between suburban and downtown areas. During the 1990s, suburban markets led in net absorption, and suburban vacancy rates dropped below downtown rates for most of the decade. By 1997, the amount of space vacant had shrunk to under 350 million square feet in the 73 markets tracked by RCG, with the vacant space almost evenly split between suburban and downtown locations. During the economic expansion in the late 1990s, close to 85% of new construction occurred in suburban areas, and downtown vacancies

dropped well below suburban rates. Suburban areas were hit much harder in the slowdown of 2001 and 2002. Several factors are likely at play. On the supply side, new suburban construction can proceed more readily than infill development in many markets. On the demand side, the types of office occupations that have been

**Figure 10**  
**Occupied and Vacant Office Space**  
**US Major Office Markets, 1991-2003**



Source: Authors from data supplied by various brokers to Rosen Consulting Group.

outsourcing most rapidly have been those that are historically located in suburban areas.

Figures 9 and 10 may actually understate the current vacancy situation in office space. Figure 10 includes both unleased space and space available for sublease in the vacant category, while some of the brokerage reports used for Figure 9 are less consistent and report only unleased space as vacant. Neither chart takes into account buildings that have been taken off the market in the most impacted areas because of the lack of leasing opportunities, or vacancies in owner occupied space that has not yet been offered for lease.

Growth in demand for office space in the US will be tempered by a number of factors of which services outsourcing is only one. Other factors include underutilized space currently under lease, the flexibility of square footage usage, and lessons in caution learned from the recent boom. These factors also are likely to interact with one another. In markets already glutted

with space, some space is being held off the market, either in whole buildings "mothballed" for the short term, or as empty space being held in anticipation of future growth in demand. These spaces could accommodate a significant increase in demand without an apparent effect on vacancy rates. As demand grows, firms that have become more dependent on the bottom line may choose a more cautious route to space utilization than in the last expansion, making more efficient use of existing space before taking on obligations for additional square footage.

Outsourcing will further dampen the growth in demand for space, and could even lead to declining demand in some markets. The Forrester Research estimate of 3.3 million jobs is equivalent to between about 500 and 800 million square feet of office space (depending on the ratio of square feet per employee)<sup>6</sup>—at the higher end

<sup>6</sup> The ULI *Office Development Handbook* reports industry standards at 200 to 250

surpassing the amount of space currently vacant in for-lease buildings nationwide. Not all of these jobs are in sectors heavily present in for-lease office space. Nevertheless, many types of office markets could feel the effects of outsourcing. Those most at risk may be back office suburban markets in slow growth or declining metropolitan areas, but the high-tech markets that are just beginning to recover from the dot-com bust may also feel the effects of the occupational restructuring that comes with services outsourcing.

### Concluding Remarks

The US economy underwent a major wave of outsourcing in manufacturing industries, a process that gathered momentum in the 1980s and 1990s and continues today. The experience of that phenomenon provides a useful benchmark for evaluating the current wave of outsourcing in the services sectors. Business process and business services outsourcing will have a significant impact on the economic landscape in the US. Several major differences distinguish services outsourcing from the previous wave of outsourcing of manufacturing jobs. Services outsourcing is structurally simpler than manufacturing outsourcing in terms of resources, space and equipment requirements and thus may proceed much more quickly. Services outsourcing affects overwhelmingly white-collar middle class jobs and occupations, unlike manufacturing outsourcing, which impacted primarily blue-collar workers. In addition, this time around it is a different set of countries that are in contention for these jobs. Figure 11 summarizes these differences and their implications for the economy.

square feet per employee, but also notes that in some markets the ratio may be as low as 150 square feet per employee.

**Figure 11**  
**Impact of Outsourcing**

Manufacturing	Services
<ul style="list-style-type: none"> <li>• Impacts blue-collar jobs</li> <li>• Affected individual industrial sectors and some specialized occupations within them</li> <li>• Job losses offset and even reversed by increases in services employment</li> <li>• Led to increased inequality between blue-collar and white-collar occupations</li> </ul>	<ul style="list-style-type: none"> <li>• Impacts white-collar jobs</li> <li>• Affects individual occupations in many industrial sectors across the economy</li> <li>• May lead to different composition of occupations in the economy; unclear how the labor market adjustment will work.</li> <li>• Will lead to increased inequality within white collar occupations</li> </ul>

While our report has focused primarily on the US economy as a whole, the economy of California is equally vulnerable. As seen in Table 1, the state's sectors at-risk to outsourcing have fared more poorly in the last two and a half years, than the US average. In terms of future impact, bear in mind that while the state does not have too many of the call center and data entry level type jobs anymore, it has a heavy presence of the computer related occupations, as well as office, legal and healthcare support jobs. Moreover, the cost differential with the rest of the world is higher, thus suggesting a higher incentive for job migration abroad. Finally, large numbers of temporary foreign employees, such as computer engineers from India in large California based firms, sensing the way the wind is blowing, have requested within-firm transfers to subsidiaries in their home countries.

While evidence from the recession of the early 1990s suggests that a major benefit of globalization has been the growth in high-tech services employ-

ment that accompanied the outsourcing of manufacturing production, it is not clear how the economy will adjust to the present burst of services outsourcing. At least four different outcomes are possible.

One possible scenario is that services job outsourcing proves more costly to the economy than the earlier round of manufacturing outsourcing. As centers of skilled high-tech professionals build up in other parts of the world, the US and California may no longer dominate the next wave of innovations, and we would observe slower growth of high-wage jobs within the US and California. In this extreme situation, economic adjustment, in the absence of continuing innovation originating in the US, first might take the form of prolonged unemployment. Then, workers losing their jobs to outsourcing would finally be absorbed in lesser-paying services jobs. Alternatively, there could be a downward adjustment of salaries and wages, making the outsourced occupations internationally competitive again. Under this worst-case scenario, the im-

pact on the demand for office space would initially be reflected in lower rents and prices, and higher vacancy rates. In the long run, with increasing employment in other jobs and occupations, rents and prices would settle on a lower growth path trajectory with vacancy rates returning to their long-run equilibrium.

As an alternative to this troubling scenario, a backlash against globalization could occur, both worldwide and within the US, slowing down the process of business services outsourcing. Opponents of globalization are already discussing protectionist measures and regulatory roadblocks in the form of restricting the kind of jobs that can be outsourced. If successful, this kind of protectionism, although inefficient from the point of view of the economy, may result in the retention of some of the outsourceable jobs. In the short run, this would moderate the negative impact on the real estate sector.

A third possibility is that the industry shrinkage shown in Table 1 may come in part from domestic outsourcing, indicating a redistribution of jobs within the US rather than a net loss. This could involve vertical disintegration—the shifting of jobs from large employers to smaller firms in support sectors—as well as the ongoing process of domestic outsourcing from high-cost regions such as California to relatively low-cost regions elsewhere in the United States.<sup>7</sup> This process would mitigate the differences in prices and rents among different regions within the nation and would leave the nationwide vacancy and absorption rates relatively unaffected.

<sup>7</sup> To the extent that the outsourced work is done by start-up firms, employment numbers may currently be undercounting the current employment situation.

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Rents in some of the higher priced markets could continue to remain depressed, even with expanding employment nationwide.

Finally, the most positive scenario is that the US and California economies continue to fashion their outsourcing activities in light of the new production paradigm, keeping the "cream" of the new development at home, while

the more routine activities are outsourced. Under this scenario, innovation would lead to a continuing stream of new service and manufacturing activities, and hence new jobs and occupations, while competition and the need for lower-cost supply would force more mature services operations overseas. Depending on their education and skills, individual workers might still find it difficult to find re-

placement employment at similar wages, but overall, the jobs lost to outsourcing would be replaced by higher-wage jobs in the new sub-sectors brought about by innovation. Increasing wages, incomes and company profits would then impact the real estate sector positively through a recovery and eventual increases in prices, rents and occupancy rates.

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*Ashok Deo Bardhan is Senior Research Associate and Cynthia A. Kroll is Senior Regional Economist at the Fisher Center for Real Estate and Urban Economics. Further information on outsourcing trends in high-tech manufacturing and services sectors and more generally on globalization and the high-tech economy is available in their forthcoming book, **Globalization and a High-Tech Economy**, coauthored with Professor Dwight M. Jaffee, Willis Booth Professor of Banking, Finance and Real Estate at the Haas School of Business and Co-Chair of the Fisher Center for Real Estate and Urban Economics.*



## NATIONAL CONFERENCE *of* STATE LEGISLATURES

*The Forum for America's Ideas*

### 2004 Offshore Outsourcing Related Legislation

#### **Banning State Agencies from Using Foreign Offshore Labor (29 States)**

Alabama	Kentucky	North Carolina
California	Maryland	South Carolina
Colorado	Michigan	South Dakota
Connecticut	Minnesota	Tennessee
Georgia	Mississippi	Vermont
Hawaii	Missouri	Virginia
Illinois	Nebraska	Washington
Indiana	New Jersey	Wisconsin
Iowa	New Mexico	West Virginia
Kansas	New York	

#### **Limiting a Company from State Government Contracts or Developmental Assistance**

Colorado  
New York  
West Virginia

#### **In State or In Country Preference for State Contracts**

Indiana  
Virginia

#### **Trade Agreement Exemption**

Colorado

#### **Consumer Right to Know Legislation (7 States)**

Arizona	South Carolina
Connecticut	Washington
Hawaii	Vermont
New Jersey	

#### **Notification of Job Loss through Offshore Outsourcing**

California  
Colorado  
West Virginia

#### **Limiting Confidential Information from Going Overseas**

Arizona  
California  
South Carolina



## NATIONAL CONFERENCE *of* STATE LEGISLATURES

*The Forum for America's Ideas*

### The National Conference of State Legislatures

#### 2004 Legislation Regulating or Prohibiting Non-U.S. Citizens from State Contracts

State	Summary	Last Action/Status
Alabama		
HB 358	Prohibits state contracts from being performed outside the U.S.	February 10, 2004; First Reading; Referred to State Government Committee
Arizona		
HB 2581	Consumer Right to Know and Act: Contains disclosure requirement, prohibition of consumer financial data from going overseas w/o consumers written consent; prohibits state from contracting with call center that does business outside the U.S.	February 11, 2004; First Reading ; Commerce and Military Affairs; Judiciary; and Rules Committee
California		
AB 1829	This bill would prohibit a state agency from contracting for services with a contractor or subcontractor unless that contractor or subcontractor certifies under penalty of perjury that the services will be performed solely with workers within the United States. This bill would also specify that these provisions do not apply if the contractor or subcontractor certifies under penalty of perjury that the services to be performed are so specialized that there are not workers within the United States that are trained to perform the services.	February 2, 2004 To Assembly Committee on Business and Professions
AB 1845	Requires a state agency that contracts for services to include a provision in those contracts that requires that only citizens of the United States and legal resident aliens in the United States will perform that contract and any subcontract performed under that contract	January 29 Introduced
SB 1452	Prohibits the state from contracting with any individual or entity that employs persons or subcontractors outside of the United States in order to perform and complete that state contract.	Introduced 2/19/04
Colorado		

State	Summary	Last Action/Status
SB 169	<p>Summary - Enacts the "Job Preservation Act of 2004". Establishes that any company that has at least 100 employees in Colorado that has had a net loss of 100 or more employees in the state during the prior calendar year and such loss was caused by the relocation of 100 or more jobs from</p> <p>Colorado to a site that is located outside the United States is ineligible to:</p> <ul style="list-style-type: none"> <li>! Enter into a procurement contract with the state or a local government;</li> <li>! Receive any government grants or loans; or</li> <li>! Use industrial development revenue bonds from the state or a local government.</li> </ul> <p>Establishes that the ineligibility lasts for 7 years. Requires any company doing business in the state of Colorado that had a net loss of 100 or more employees in the state during the prior calendar year to notify the department of labor and employment of the loss. Requires the executive director of the department to send a survey to such company in order to determine, among other things, the number of the jobs that Colorado employees lost as a result of the company outsourcing the jobs to employees located outside of the United States. Requires the executive director to provide written notice to specified agencies of state and local government. Makes legislative findings and declarations. Defines terms.</p>	
SB 170	<p>Enacts the "Keep Jobs in Colorado Act" as part of the "Procurement Code". Declares that any consent given by a state official to be bound by the government procurement rules of an international trade agreement is invalid and that the state does not consider itself bound by such agreement. Requires the attorney general to notify the United</p> <p>States trade representative of the general assembly's position. Prohibits the executive director and the purchasing agent for each purchasing agency from awarding a procurement contract for services to be rendered or supplies delivered from a site that is outside the United States. Requires each person submitting a bid to provide services or supplies for a governmental body to certify that the services to be rendered and supplies to be delivered shall be from a site within the United States. Establishes the same prohibition and requirement on professional service contracts, which are not covered by the "Procurement Code".</p>	February 9, 2004 to senate Committee on Veterans and Military Affairs
Connecticut		
SB 430	<p>Every contract to which the state or any political subdivision of the state other than a municipality is a party shall contain the following provision: The contractor agrees and warrants that in the performance of the contract such contractor will not use any subcontractor, person or group of persons from a site that is located outside the United States or transfer any of the contracted work or service to a location outside the United States, unless the contracted work or service is related to a proceeding or event that occurs outside the United States.</p>	February 24, 2004 To Labor Committee
Georgia		

State	Summary	Last Action/Status
HB 1281	No contract between a state agency and a private provider or vendor for the provision of all or part of any governmental services provided by the agency or for the provision of any services to the agency shall be entered into if any such services will be performed outside the boundaries of the United States. If at any time during the performance of a contract the private contracting party uses any services which are performed outside the boundaries of the United States, such private contracting party shall be liable to the state agency for damages in an amount equal to the contract value of such services.	Passed out of State Institutions and Property
Hawaii		
HB 1922	Requires public contracts for telemarketing services to be performed in the United States. Gives consumers right to know the location of a call center.	January 26, 2004: First Reading; Referred to Consumer Protection and Commerce; Judiciary Committees
Illinois		
HB 4550	Requires that each State contract include the contractor's certification that services performed under the contract or a subcontract shall be performed within the United States by U.S. citizens, holders of valid U.S. immigrant visas, or both. Effective immediately.	February 3, 2004; Referred to Rules Committee
SB 2375	Requires that State contracts include the contractor's certification that services performed under the contract or a subcontract shall be performed within the United States. Requires the Procurement Policy Board to establish any exemptions. Requires that a contract be voided for violation of the certification if the chief procurement officer deems it to be in the best interest of the State.	February 4, 2004; Assigned to State Government Committee
Indiana		
SB 4	Award of state contracts. Requires the state's procurement practices to be supportive of retention and creation of jobs in Indiana. Provides that a contract or solicitation for a contract to privatize any of the functions performed by a governmental body's employees that would result in the layoff or dismissal of any of those employees must: (1) require an offeror to provide verifiable evidence that the cost of the contract will be less than the cost of having the functions performed by the governmental body's employees; (2) specify that the governmental body may not pay the contractor more than the cost the governmental body determined the governmental body would incur to perform the functions using its own employees; (3) require the governmental body to provide to an offeror an estimate of the cost of having the functions performed by the governmental body's employees; and (4) contain a statement that the governmental body may pursue certain remedies if the contractor fails to comply with the contract. Permits a representative of any group of the governmental body's employees to submit an offer for the group to perform the functions and requires the governmental body to award the contract to the group of employees under certain circumstances.	February 2, 2004 Passed out of Senate  Sent to House Committee on Appointments and Claims
HB 1275	Provides a 10% price preference to Indiana businesses for public	January 15, 2004; First

State	Summary	Last Action/Status
	works and contracts for services and supplies awarded by the state; provides that a contract for services entered into by a state agency must specify that only citizens of the United States and individuals authorized to work in the United States may be employed in the performance of services under the contract or any subcontract	reading: referred to House Committee on Appointments and Claims
HB 1381	Provides that a contract for services entered into by a state agency must specify that only citizens of the United States and individuals authorized to work in the United States may be employed in the performance of services under the contract or any subcontract	January 20, 2004; First reading: referred to House Committee on Appointments and Claims
HB 1101	Provides that a contract for services entered into by a state agency must specify that only citizens of the United States and individuals authorized to work in the United States may be employed in the performance of services under the contract or any subcontract	January 13, 2004; First reading: referred to House Committee on Appointments and Claims
Iowa		
HF 2400	Requires all work done under a state contract to be performed within the boundaries of the United States	Introduced March 1, 2004
SB 2063	This bill prohibits state entities from awarding a contract to a nonresident alien or to a person for a contract or subcontract for services to be performed outside the United States.	Introduced
Kansas		
HB 2524	Enacts the American Jobs Act, relates to state procurement of contractual services; prescribing certain restrictions on foreign contractors.	January 16, 2004; Referred to House Commerce and Labor Committee
Maryland		
HB 183	Prohibiting a procurement unit from awarding a contract for services to be rendered by a contractor or subcontractor from a site that is located outside the United States; providing exceptions to the prohibition; establishing that these procurement provisions of law apply to specified procurements; and requiring specified notice in invitations for bids and requests of proposals for service procurements.	January 16, 2004; First Reading-Health and Government Operations
Michigan		
HB 4940	Requirement for state contracts to be awarded to only citizens or legal residents of the United States	Carried Over from 2003 Referred to the Committee on Government Operations
Minnesota		
H.F. 1816	Relating to state government; requiring that state agency contracts for services be performed by United States citizens or by individuals authorized to work in the United States	February 5, 2004 Introduced to Governmental Operations and Veterans Affairs Policy
S.F. 1792	Relating to state government; requiring that state agency contracts for services be performed by United States citizens or by individuals authorized to work in the United States	February 5, 2004 Introduced to State and Local Government Operations
Mississippi		
HB 464	State contracts; prohibit granting to those contractors employing persons who are not American citizens or legal aliens	January 20, 2004 To House Committee on Appropriations
Missouri		
SB 1029	Prohibits state contracts from being awarded to any	January 20, 2004; Second

State	Summary	Last Action/Status
	contractor or subcontractor who performs the contracted work outside the United States. Further the act establishes penalties and required termination of any contract where the contractor or contractor after being awarded the contract transfers the contracted work to a location outside the United States	Read and Referred Senate Financial & Governmental Committee
Nebraska		
LB 1223	State agencies may not award a contract to a Contractor or subcontractor who performs the work at a site outside of the United States unless refusing to award a particular contract would violate the specific terms to which the State of Nebraska	Introduced
New Jersey		
SB 494	Directs the Director of the Division of Purchase and Property and the Director of the Division of Property Management and Construction in the Department of the Treasury to include in every state contract for the performance of services provisions which specify that only citizens of the United States and persons authorized to work in the United States pursuant to federal law may be employed in the performance of services under the contract or any subcontract awarded under the contract	January 13, 2004; Introduced in the Senate, Referred to Senate State Government Committee
New Mexico		
SB 416	Requiring public contracts for the performance of services to provide that only citizens and persons authorized to work in the United States be employed under the contract or subcontract awarded under the contract	Introduced
New York		
AB 1092	Enacts the "Employment and Job Training Services Act"; requires state or local government agencies and private organizations contracting with the state that provide employment services including job training, retraining or placement, to verify an individual's legal status prior to providing such services; requires notice by such agencies to potential job seekers stating that only citizens of the United States will be eligible for such services	January 14, 2003; To Assembly- Committee on Labor
AB 9657	Prohibits the outsourcing of jobs by business entities receiving state developmental assistance; provides for repayment thereof and a five year ban on assistance for violations; provides for enforcement by the attorney general	January 28, 2004 To Assembly Committee on Economic Development, Job Creation, Commerce and Industry
SB 6040	Prohibits the outsourcing of jobs by business entities receiving state developmental assistance; provides for repayment thereof and a five year ban on assistance for violations; provides for enforcement by the attorney general	January 7, 2004 To Senate Committee on Corporations
North Carolina		

State	Summary	Last Action/Status
SB 991	Provides that State government shall require in every contract for the performance of telemarketing services provisions that only citizens of the United States and persons authorized to work in the United States may be employed, and to provide for disclosure of certain information from customer sales and service centers	Session starts in May
Rhode Island		
HB 5678	This act would establish a comprehensive and fair procedure for all state agencies to follow before they can contract out-of-state programs and services	February 11, 2004 To House Committee on Labor
South Carolina		
HB 4434	Provides that an expenditure of state funds under contract through a governmental body for telemarketing services requires contract provisions that the services must be performed in the United States and that only United States citizens and persons authorized to work in the United States may be employed; and relates to the regulation of unsolicited telephone calls, so as to provide for disclosure of certain information from a consumer sales or service call center	January 13, 2004; Referred to House Committee on Labor, Commerce and Industry
South Dakota		
HB 1116	An Act to prohibit the state from contracting for services to be provided by persons outside the United States or persons not authorized to work in the United States.	January 28, 2004 passed out of State Affairs Committee
Tennessee		
SB 2344	Concerns public contracts; requires every state contract for performance of services to contain provisions specifying that only U.S. citizens residing in the states or persons authorized to work in the U.S. pursuant to federal law including legal U.S. resident aliens shall be employed in performance of services under the contract or any subcontract awarded under the contract	January 26, 2004 To Senate Committee on State and Local Government
Vermont		
HB 647	Prohibits the state from contracting with a call center located outside of the United States; also includes some Consumer Right to Know and Act language (disclosure).	January 28, 2004; First Reading in Government Operations
HB 702	Prohibits any unit of state government from awarding a contract for services to be rendered by persons from a site that is located outside the United States.	February 3, 2004; First Reading; Referred to Government Operations Committee
Virginia		
HB 1010	The bill provides that no public body shall enter into any contract for professional services unless the contract provides that only citizens of the United States, legal resident aliens, and individuals with a valid visa will perform the services under the contract or any subcontract of that contract.	February 3, 2004 Passed House General Laws Sub Committee

State	Summary	Last Action/Status
HB 243	Provides that in determining the award of any contract for goods or nonprofessional services, a public body shall give preference to goods produced in the United States, or to goods or nonprofessional services provided by U.S.-based firms or corporations, so long as the bid price of such firm or corporation is not more than 20 percent greater than the bid price of the low responsive and responsible foreign-based firm or corporation. The bill provides that such contract may be awarded to a foreign-based firm or corporation in accordance if it is a sole source contract. The bill defines "foreign-based firm or corporation" as a firm or corporation based outside of the United States or any of its territories.	February 3, 2004 Passed House General Laws Sub Committee
HB 315	Provides that in awarding contracts in excess of \$500,000 for the procurement of goods or services, state public bodies shall give a 3 percent preference to any person with facilities located in Virginia that manufacture, develop, produce, grow, mine, or make such goods or services.	February 3, 2004 Passed House General Laws Sub Committee
SB 151	Provides that in determining the award of any contract for goods or nonprofessional services, a public body shall give preference to goods produced in the United States, or to goods or nonprofessional services provided by U.S.-based firms or corporations, so long as the bid price of such firm or corporation is not more than 20 percent greater than the bid price of the low responsive and responsible foreign-based firm or corporation. The bill provides that such contract may be awarded to a foreign-based firm or corporation in accordance if it is a sole source contract. The bill defines "foreign-based firm or corporation" as a firm or corporation based outside of the United States or any of its territories.	
Washington		
HB 2768	Relating to requiring state contracts be performed by citizens of the United States or persons authorized by federal law to work in the United States	January 20, 2004; First reading, referred to House Commerce & Labor Committee
SHB 3187	Prohibits work under certain state contracts from being performed at locations outside the United States. -- Makes this prohibition applicable to state personal services, purchased services, and civil service contracts.-- Makes this prohibition inapplicable if the Director of the Office of Financial Management determines that the only practicable location where the services may be performed is clearly and justifiably outside the United States.-- Also makes this prohibition inapplicable to goods procured under certain state contracts, and to certain state contracts entered into prior to July 1, 2005.	Passed out of House Commerce & Labor Committee

State	Summary	Last Action/Status
ESHB 2459	The state's supplemental operating budget -- passed out of the House on February 25, 2004. It includes a budget proviso requiring the Office of Financial Management to report to certain legislative committees on its review of certain contracts performed at locations outside the United States and other issues related to outsourcing by December 1, 2004	
Wisconsin		
AB 761	With certain exceptions, this bill requires all contractual services purchased by executive branch agencies to be performed within the United States. This requirement does not apply if the contractual services cannot be obtained within the United States.	January 14, 2004; Referred to Government Operations and Spending Limitations Committee
SB 389	With certain exceptions, this bill requires all contractual services purchased by executive branch agencies to be performed within the United States. This requirement does not apply if the contractual services cannot be obtained within the United States.	January 14, 2004; Referred to committee on Homeland Security, Veterans and Military Affairs and Government Reform

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## NATIONAL CONFERENCE *of* STATE LEGISLATURES

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### The National Conference of State Legislatures

#### 2004 Legislation Regulating or Prohibiting Overseas Outsourcing

- Privacy
- Call Centers

Arizona		
HB 2581	Concerns telephone solicitations; requires disclosure by consumer services employee of the complete street address, including city, state and county and the consumer services employee's true legal name; prohibits such employee from sending a person's financial, credit or identifying information to any foreign county unless the person gives express written permission; amends provisions regarding state contracts for telephone solicitation services.	Introduced
California		
SB 1492	Declares the Legislature's intent to enact legislation to ensure that no work involving information that is private, confidential, privileged, or essential to homeland security is performed at a worksite outside of the United States.	Introduced 2/19/04
SB 1451	legislation that addresses the growing threat to privacy by individuals or corporations that contract or subcontract with individuals located outside of the United States that handle or come into contact with private medical and financial information.	Introduced
SB 1453	This bill would require any employer that outsources jobs that would result in the replacement of 20 or more workers in California to, not less than 60 days before the employer enters into a contract with a contractor or subcontractor located outside the United States to perform the outsourced job functions, give written notice of the contract to the Employment Development department and the employees based in California whose jobs would be affected by the outsourcing.	Introduced

AB 2163	Requires any person or entity hired by a provider of health care for the purpose of transcribing or processing medical records containing medical information to disclose to the provider of health care all contractors or subcontractors used. Also requires that person or entity to disclose to the provider of health care whether any of the medical records containing medical information will be sent offshore to other countries for transcribing or processing and would require the provider of health care to first obtain the consent of the patient for that action.	2/18/04
Colorado		
HB 1289	Requires a commercial call center receiving a consumer's call to immediately, upon the consumer's request, identify the location of the call Center, the identity of the employee the consumer is speaking with, and the true legal name or trade name of the operator of the call center. Requires a consumer's express, written permission before a telephone call containing personal information may be routed into or through a foreign country. Defines the failure of a business to provide such notice or obtain such consent as a deceptive trade practice, subject to existing penalties	
New Jersey		
AB 840	Requires an employee of an inbound call center who responds to an electronic mail message from a resident of New Jersey to identify: himself, by stating his name, or official company registration or alias; the name of his employer; the state and country in which he is located; and, if applicable, the name and telephone number of a customer service representative of the entity utilizing the services of his employer	January 13, 2004; Introduced, Referred to Assembly State Government Committee
SB 370	Requires an employee of an inbound call center who responds to an electronic mail message from a resident of New Jersey to identify: himself, by stating his name, or official company registration or alias; the name of his employer; the state and country in which he is located; and, if applicable, the name and telephone number of a customer service representative of the entity utilizing the services of his employer	January 13, 2004; Introduced in the Senate, Referred to Senate Commerce Committee
South Carolina		
HB 4434	Provides that an expenditure of state funds under contract through a governmental body for telemarketing services requires contract provisions that the services must be performed in the United States and that only United States citizens and persons authorized to work in the United States may be employed; and provides for disclosure of certain information from a consumer sales or service call centers; prohibits the financial, credit, or identifying information of a person being sent to any foreign country without express written permission of that person.	
Washington		

HB 2351	<p>Requires that, at the request of a party using telephonic or electronic communications with an employee of a contact center, the employee must identify: (1) Himself or herself, by stating his or her name; (2) The name of his or her employer; (3) The location of the municipality, state, and country in which he or she is located; and (4) If applicable, the name and telephone number of the entity contracting with the contact center. In addition, if the contact center is located in a foreign country, the party may request that a telephonic communication be rerouted to a contact center located in the United States. The contact center must comply with any such request. Provides that an employee at a contact center operating in a foreign country may not solicit any personal information, whether using telephonic or electronic communications, unless the employee first informs the party that disclosing that information to the employee is optional and receives the affirmative consent of the party to whom the information relates.</p>	<p>January 12, 2004; First reading, referred to House Commerce &amp; Labor Committee</p>
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## 2004 California State Legislation on Outsourcing

**SB 1451 (Figueroa)** This bill expresses the intent of the Legislature to enact legislation that addresses the growing threat to privacy by individuals or corporations that contract or subcontract with individuals located outside of the U.S. that handle or come into contact with private medical and financial information.

**SB 1452 (Figueroa)** This bill, to the extent not in conflict with federal law, would prohibit the state from contracting with an individual or entity that employs persons or subcontractors outside of the U.S. in order to perform and complete that state contract.

**SB 1453 (Figueroa)** This bill would require any employer that outsources jobs overseas that would result in the replacement of 20 or more workers to give written notice of the contract to the Employment Development Department and the employees based in California whose jobs would be outsourced.

**SB 1492 (Dunn)** This bill would declare the Legislature's intent to enact legislation to ensure that no work involving information that is private, confidential, privileged or essential to homeland security be performed at a worksite outside the U.S.

**SB 1638 (Romero)** This bill would require the Governor to submit, as part of the state budget, information for all current and proposed service contracts and to post the information on the state website.

**AB 664 (Correa)** This bill would require a person or entity conducting business in California that shares personal information with offices, subcontractors or subsidiaries outside of the U.S. to disclose to the customer the type of information shared and country where the information may be shared.

**AB 1829 (Liu)** This bill would require all state contractors and subcontractors for service to sign, under penalty of perjury, that the contract would be performed solely by workers located in the U.S.

**AB 1845 (Lowenthal)** This bill would require state agencies that contract for services to include a provision in the contracts to require that only U.S. citizens and legal resident aliens in the United States will perform the contract and subcontract work.

**AB 2124 (Campbell)** This bill would remove the Department of Industrial Relations requirement that all bidders on state contracts sign the Sweatfree Code of Conduct. This bill would also limit the state contracts that are subject to the labor standards certification requirements.

**AB 2163 (Leslie)** This bill would require individuals or entities performing medical records transcription or processing to 1) disclose to the health care provider all contractors or subcontractors to be used for the service, 2) disclose to the health care provider whether any of

the medical records will be sent offshore 3) require the health care provider to obtain consent of the patient before medical records are offshored.

**AB 2449 (Diaz)** This bill would require state agencies and recipients of state funds to give preferences to contractors or vendors who provide written verification that information technology service work provided by the contractor will be performed in the United States. This bill provides an exemption should the Governor declare a state of emergency.

**AB 2588 (Reyes)** This bill would prohibit health care providers and insurers from disclosing medical information to a 3rd-party for the purpose of medical data processing or medical record transcription.

**AB 2919 (Ridley-Thomas)** This bill would prohibit the Department of General Services from contracting for telecommunication services with any vendor or provider that employs nonresidents of the United States in the performance of the telecommunication services on behalf of the state or local agency.

**AB 3021 (Koretz)** This bill would require employers to report to the Employment Development Department annually the number of jobs maintained in California, in other states, and outside the U.S.

# Assessing Privacy Risk in Outsourcing



Healthcare providers can outsource transcription, but they can't outsource their obligation to safeguard privacy. Here's how to minimize risk.

by **Margaret Davino**

**H**ealthcare providers are faced with multiple pressures, many of them financial. The need for management to meet financial constraints often translates into a desire to contract with vendors at the lowest possible immediate cost, sometimes without thought as to the nonprice issues in a contract.

It is important to linger over the legal issues that may be associated with vendor contracts, especially with vendors that may subcontract portions of their tasks. The October 2003 incident in which a Pakistani subcontractor, in a dispute with a medical transcription company, threatened to release patient information on the Web provided a dramatic reminder of this. Provider and vendor liability has become even more important in light of HIPAA privacy and security regulations, which place

an obligation on covered healthcare providers to ensure that their vendors safeguard confidentiality.

This article discusses specifically the considerations that should be given by healthcare providers when choosing a medical transcription vendor, and it offers tips to protect providers when entering into a medical transcription contract.

## Transcription Outsourcing

Medical transcription is a vital part of healthcare operations. Accurate, timely transcription of daily notes such as operating room reports, discharge summaries, and radiology reports is essential for communication among healthcare providers. Transcription further factors into accurate coding and billing of services, satisfaction of regulatory requirements, and defense of medical malpractice suits. In recent years it has become important in the development of electronic health records.

Transcription is also a frequent candidate for outsourcing. Healthcare providers often contract out their transcription as a cost-saving measure (though cost savings may not be possible in all circumstances). Providers also choose outsourcing to meet staffing challenges posed by local labor markets, the need for specialized training, and their own staffing limitations.

Whatever the motivation for outsourcing, transmission of confidential medical information outside of facility walls places an obligation on the provider to ensure that the vendor protects the confidentiality of the information. HIPAA requirements make this issue more critical than ever before.

The case in which the Pakistani subcontractor threatened to release patient information illustrates how important it is for providers to choose vendors carefully to complete due diligence with regard to chains of subcontracting and to protect themselves contractually from liability for acts of the vendor or the vendor's subcontractors.

The above story started in fall 2003 when the University of California at San Francisco Medical Center (UCSF) forwarded a portion of its transcription work to Transcription Stat, a company it had used for two decades. Transcription Stat employs 15 subcontractors throughout the US to handle the large volume of files it receives daily from UCSF. One of those subcontractors, a woman in Florida, further subcontracted the work to a man in Texas named Tom Spires.

Allegedly unbeknownst to the other parties, Spires also employed subcontractors, one of whom was a Pakistani woman, Lubna Baloch. On October 7, 2003, UCSF received an e-mail from Baloch stating that Spires owed her money and would not respond to her. Baloch demanded that UCSF require Spires to pay her. If not paid, Baloch wrote, she would "expose all the voice files and patient records of UCSF . . . on the Internet."<sup>1</sup> To show that she was serious, Baloch attached dictation reports from UCSF physicians regarding two patients.

One of the contracted parties involved ultimately paid Baloch, who then retracted her threat. Although the incident ended without a breach of patient privacy, the situation dramatically illustrated the risks for parties involved at all points in the chain. How can a provider best protect itself from a situation such as this?

## What HIPAA Requires

The privacy regulations of the federal HIPAA law, effective April 14, 2003, were intended to ensure the privacy and confidentiality of personal health information. HIPAA's privacy rules apply only to healthcare providers, payers, and clearinghouses that are covered entities. Because the law does not directly apply to other parties that may handle medical information (e.g., transcription companies and other vendors), HIPAA attempts to stretch its coverage by requiring healthcare providers to take certain actions when entrusting medical information to vendors.

HIPAA requires that if a provider releases medical information to another person or entity to perform a function on the

Transmission of confidential medical information outside of facility walls places an obligation on the provider to ensure that the vendor protects the confidentiality of the information.

provider's behalf (the provider's "business associate"), the provider must enter into an agreement obliging the business associate to maintain the confidentiality of the medical information.

HIPAA's privacy regulations require that business associate contracts contain several specific provisions. The contract must specify the permitted uses and disclosures of information by the business associate. The contract also must require the business associate not to use or further disclose the information except as permitted by the contract and to use appropriate safeguards to prevent use or disclosure of the information other than as allowed by the contract. The contract must "ensure that any agents, including a subcontractor," to whom the business associate provides medical information agree to the "same restrictions and conditions that apply to the business associate with respect to such information." The contract must authorize termination if the business associate violates a material term of the contract.

When the HIPAA security rule goes into effect, medical transcription vendors will be covered as business associates under this rule also, because the security rule applies to electronic medical information, both in storage and in transmission. The rule requires that when providers contract with business associates who "create, receive, maintain or transmit electronic protected health information," the contract specify appropriate use of the information.

Additional security provisions may need to be added to business associate contracts with transcription vendors and other business associates that receive or transmit electronic information. For example, the security regulations require that any business associate shall "(i) implement administrative, physical, and technical safeguards that reasonably and appropriately protect the confidentiality, integrity and availability of electronic protected health information that it creates, receives, maintains or transmits on behalf of the covered entity, as required by the security standards. (ii) ensure that any agent, including subcontractors to whom the business associate provides such information, agrees to imple-

relating" to the electronic information that the vendor maintains for the provider.

### What Providers Should Determine

Providers should therefore determine how a medical transcription vendor maintains the privacy of medical information and how the vendor safeguards the security of electronic information. Providers should get answers to the following questions:

- Does the vendor have security safeguards for information that is maintained at the vendor's data headquarters (e.g., is each employee required to have a secure password)? Are voice files and data files maintained in a secure data safe?
- Is there an audit trail that shows who has accessed data in the vendor's archive system?
- How long are data files maintained, and are they destroyed after that period? Are voice files automatically deleted within a reasonable time after being transcribed? The provider may wish to specify that data is maintained only until the provider ensures that the transcribed report is in the medical record (e.g., no more than one year).
- Is electronic medical information transmitted from the vendor to the provider in a secure fashion—for example, through encryption?
- How does the vendor regulate provider access to the provider's directory on the vendor server? For example, is it safest to allow only one person authorized by the provider (e.g., the director of medical records) to draw data down from the transcription vendor's computer system?
- If the vendor employs home-based transcriptionists, does the vendor have policies to safeguard workstations? Are home-based transcriptionists allowed to store provider files on their home computers?

Providers should therefore determine how a medical transcription vendor maintains the privacy of medical information and how the vendor safeguards the security of electronic information.

ment reasonable and appropriate safeguards to protect it, and (iii) report to the covered entity any security incident

### Minimizing Risk

Providers can consider a number of options when entering into a contract for medical transcription services. These options can clarify the mutual understanding of the contractual relationship, minimize the chance of a HIPAA or confidentiality violation, and ensure that the provider will be able to take appropriate action should a vendor fail to meet required standards.

1. Ensure that the contract with the medical transcription company obligates the vendor to not only maintain confidentiality itself, but to **require any person or entity to whom the vendor sends information to maintain confidentiality and security** of information. The vendor should require that the person or entity comply with all of the obligations of the vendor under the vendor's business associate agreement with the provider.

In the UCSF case, the transcription vendor, the first

subcontractor, and second subcontractor were simply intermediaries. That realization makes a provider wonder how many transcription vendors operate by simply contracting with another party whose cost is low enough to allow the first vendor to skim off a profit, and so on down the line until the only person left to do the work is someone whose wages are below those livable in the US. It is difficult to ascertain how HIPAA's privacy or security requirements can be satisfied if a transcription company is simply a pass-through: can anyone identify who has the data, how it is stored, or where it is? Nevertheless, the HIPAA rule assists providers by making clear that vendors are responsible for the privacy and security of the data given to them.

The obligations of both provider and business associate become further complicated if some of the parties receiving information are not located inside the United States. Entities not domiciled in the US may not be subject to, or even aware of, US laws.

2. **Require indemnification** from the vendor for any breach of the contract (including confidentiality), not only by the vendor but by any of the vendor's subcontractors or entities to which the subcontractor may send information.
3. **Consider placing restrictions on the subcontractors that a vendor may use;** for instance, explicitly requiring that any subcontractor receiving medical information from the vendor be physically located in the United States and that, in addition, the vendor's subcontractors be explicitly prohibited from sending any of the provider's information outside the US. Although this will not obviate the problems that can occur if a subcontractor isn't paid and threatens release of information, for example, it will ensure that any such subcontractor is subject to US law and may be less likely to make such threats. Also, providers can consider asking vendors outright for a full disclosure of subcontracts.
4. **Consider using a medical transcription company that does not subcontract** any work at all. Some vendors are staffed with full-time employees who receive benefits, and some offer incentives to staff for meeting high performance standards. Some vendors assign transcriptionists responsibility for a single client, fostering familiarity with the client's transcription needs. Such vendors may charge a premium for that level of service, but providers may want to balance that cost with the potential benefits of a stable, dedicated staff.
5. **Consider whether the transcription company is making investments** to obtain and retain the provider as a customer. Is it purchasing computers and equipment for use on the account, or is it simply subcontracting all work and keeping a percentage of the fee? The answer gives the provider a clue as to how much the vendor values the relationship and how carefully other contract terms should be reviewed.
6. **Ensure protection by including specific performance standards** in the contract. These should include turn-around time, error rate, and template consistency (so that

the documents follow a standard format). Not only are written performance standards important to give the provider the ability to terminate the contract if standards are not met, they also can help identify hidden costs. Although one vendor may appear to be less costly than another, does a high error rate require the provider to allocate time from other employees to review, edit, and correct the vendor's work?

7. **Weigh the cost of training staff** regarding confidentiality. HIPAA requires that all persons with access to personal health information receive training on the confidentiality requirements of the law. In addition, laws in some states require additional staff training for specific situations, such as New York's AIDS confidentiality law. It can be easier for the provider to place the burden of training on the transcription company.

8. **Ensure that the contract contains the protection terms** standard in any contract: (1) the ability (of both parties) to terminate the contract for cause (e.g., failure to comply with the terms of the contract) and not for cause (if the vendor has made a substantial capital investment in the provider's account, this clause may only be agreed upon if the provider takes some responsibility for the investment); (2) an appropriate length of time for the contract; (3) inability of the vendor to assign the contract without the provider's permission; and (4) a requirement that any claim be brought in the state in which the provider is located.

In the wake of the UCSF case, a California state senator discussed introducing legislation that would prohibit provider and payer organizations in California from sending confidential medical information outside of the United States for transcription or other outsourced data processing activities.

Such a law would ensure that all vendors and their subcontractors are subject to US laws, but it would not alter a

provider's core responsibilities when transmitting confidential records to a vendor. Meeting responsibilities and minimizing risk will still require asking the right questions, weighing the options, and establishing an appropriate business associate agreement. ♦

#### Note

1. Lazarus, David. "A Tough Lesson on Medical Privacy: Pakistani Transcriber Threatens UCSF over Back Pay." *San Francisco Chronicle* (October 22, 2003). Available online at <http://sfgate.com>.

#### Acknowledgement

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AICPA ALERT

Members must comply with the Code of Professional Conduct and other pronouncements.

# Legal and Ethical Considerations Regarding Outsourcing

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BY RICHARD I. MILLER AND ALAN W. ANDERSON

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## EXECUTIVE SUMMARY

- **THE AICPA HAS RECEIVED A NUMBER** of inquiries regarding practitioners' responsibilities in outsourcing engagements. The applicable guidance is found in the AICPA's Code of Professional Conduct, the Gramm-Leach-Bliley Act and certain Internal Revenue Code provisions.
- **THE CODE OF PROFESSIONAL CONDUCT STATES** that a member remains responsible for ensuring the accuracy and completeness of the services rendered by the third-party provider.
- **MEMBERS SHOULD SATISFY THEMSELVES** regarding the competence, practices and procedures of any third-party provider, regardless of the type of services provided or the location at which they are performed. At a minimum, it seems advisable for members to discuss with the third party the specific controls in place to safeguard the client's information and to satisfy themselves such controls are adequate.
- **WHATEVER THE MEASURES USED BY THE** third-party provider, the member should be satisfied that reasonable efforts are undertaken to assure the confidentiality of the information to which the provider has access. A confidentiality breach by the outsourcer, even if all of the noted steps were taken, will still be the responsibility of the member.
- **THE CODE OF PROFESSIONAL CONDUCT DOES NOT** require members to advise clients regarding their use of a third-party provider.

members to advise clients regarding their use of a third-party provider. Such disclosure is at the sole discretion of the practitioner. Advising clients of the use of third-party providers, however, in no way relieves members of their responsibilities to comply with the code as discussed in the article.

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**T**he Institute has received a number of inquiries regarding the responsibilities of members who use third-party service providers in client engagements. Commonly known as “outsourcing,” this practice has been employed by members for decades to provide more effective services to their clients. Examples of services that may be outsourced include

- Tax preparation and processing.
- Bookkeeping.
- Certain audit procedures performed by contract staff.
- Outside specialist services in connection with an audit.
- Human resources services.
- Investment advisory services.
- Workpaper storage or destruction services.

This paper will discuss member responsibilities in three areas: AICPA ethical standards, the Gramm-Leach-Bliley Act (GLBA) and certain Internal Revenue Code provisions.

### **AICPA ETHICAL STANDARDS**

The AICPA’s professional ethics division addressed the use of third-party providers as early as 1973 in Ethics Ruling no. 1, under the AICPA Code of Professional Conduct, Rule 301, Computer Processing of Client Returns (ET section 391.001–.002). While that ethics ruling specifically deals with using outside services to process tax returns, it also would apply to any use of third-party providers. The ruling advises that members “must take all necessary precautions to be sure the use of outside services does not result in the release of confidential information.” (Because of continuing questions concerning the use of third-party providers, the professional ethics executive committee [PEEC] in its meeting on January 22, 2004, appointed a task force to study whether this ruling needs to be revised. Should any further guidance be issued by the PEEC, it will be made available to members as soon as practicable.)

The code also states that a member remains responsible for ensuring the accuracy and completeness of the services provided by the third-party provider. Specifically, it requires all professional services to be performed with professional competence and due professional care (see Rule 201, General Standards [ET section 201.01]). Accordingly, using third-party providers to assist in performing services for clients does not in any way excuse practitioners from these or other responsibilities under the code.

In view of these requirements, members should satisfy themselves regarding the

In view of these requirements, members should satisfy themselves regarding the competence, practices and procedures of any third-party provider, regardless of the type of services provided or the location at which they are performed. At a minimum, it seems advisable for members to discuss with the third party the specific controls in place to safeguard the client's information and to satisfy themselves that such controls are adequate. For example, where client information is transmitted via the Internet, the member may want to inquire as to specific security measures in place, such as

- Encryption techniques.
- The use of private leased lines or virtual private networking connections with authorized users.
- The availability and processing integrity of the information.
- Whether the third-party provider has had an engagement performed (internal or external) on the security of their systems.
- Whether the third-party provider has obtained an independent security attestation regarding their systems.

Once satisfied there are sufficient procedures in place to ensure the security of information transmitted electronically to a third-party provider, members also should satisfy themselves that controls are in place to ensure the information remains confidential. There are many ways by which third-party providers might satisfy a practitioner in this regard. For example, they may use nondisclosure agreements with their employees; implement certain computer protections that prohibit downloading, printing, scanning or copying a client's financial information; and incorporate firewall security to prevent outsiders from hacking into the system. Periodic testing of these security measures could also provide more comfort to the practitioner. Whatever the measures used by the third-party provider, the member should be satisfied that reasonable efforts are undertaken to assure the confidentiality of the information to which the provider has access. A confidentiality breach by the outsourcer, even if all of the above steps were taken, still will be the responsibility of the member. (The subjects of security, privacy, confidentiality, online processing and availability, among others, are covered in the AICPA/CICA Trust Services Principles and Criteria Framework, available at [www.aicpa.org/trustservices](http://www.aicpa.org/trustservices)).

As part of their overall responsibility to ensure that all professional services are performed with professional competence and due professional care, members are responsible for adequate supervision of all such professional services. The member should review all work performed by a third-party provider since he or she will remain fully responsible for the accuracy and completeness of the services provided.

Should a question be raised regarding a member's compliance with any of his or her professional responsibilities, including those discussed above, the member may be in a better position if he or she can demonstrate that he or she took reasonable steps to meet those obligations.

The code does not require members to advise clients regarding their use of a third-party provider. Therefore, advising the client of such use is at the sole discretion of the member unless the client questions the member regarding such practice. However, whether or not clients are advised of the use of third-party providers, members are not relieved of their responsibilities to comply with the code as outlined above.

### **GRAMM-LEACH-BLILEY ACT**

In addition to the member's responsibilities under the code to maintain confidentiality, the Gramm-Leach-Bliley Act of 1999 needs to be considered as well. In GLBA, Congress included protections that allowed consumers to determine when personal financial information could be shared among financial service institutions. The Federal Trade Commission (FTC), one of the federal agencies charged with implementing the privacy requirements of the GLBA, promulgated a set of rules that govern the use of consumer financial information ([www.ftc.gov/privacy/privacyinitiatives/financial\\_rule\\_lr.html](http://www.ftc.gov/privacy/privacyinitiatives/financial_rule_lr.html)).

These rules, particularly 16 CFR [Code of Federal Regulations] section 313.4, require persons or businesses offering financial services for personal, family or household purposes to provide notices regarding their information-sharing policies and practices. The notices must be provided to ongoing customers at the time the customer relationship begins and, according to 16 CFR section 313.5, annually thereafter. A person who provides personal, nonpublic information to obtain financial, investment or economic advisory services, regardless of whether there is a continuing customer relationship, is also entitled to notice prior to, and the ability to opt out of, any actual disclosure of such information to a nonaffiliated third party. Therefore, as currently interpreted, GLBA requires practitioners who provide, among other things, tax planning and tax preparation services to individual clients, to give notice of the practitioner's policy regarding disclosure of private information at the start of an engagement, and annually thereafter.

The notices required by GLBA generally require disclosure to the client of categories of nonaffiliated third parties to whom there is disclosure of nonpublic information, under section 313.6. GLBA does not, however, require that a practitioner specifically disclose to a client the fact that independent third-party providers are used in performing services for clients. Section 313.14 provides an exception to the notice and opt-out requirements for "processing and servicing transactions." In summary, the notice and opt-out requirements described above do not apply if (1) the practitioner shares nonpublic personal information in connection with servicing or processing a financial product or service that a consumer requests or authorizes or (2) the sharing of information with the third party is required, or is a usual, appropriate or acceptable method to carry out the transaction or service of which the transaction is a part, or to record, service or maintain the consumer's account in the ordinary course of providing the financial service or product.

In other words, if the third-party provider is connected to or involved in the provision (or processing) of the services offered by the practitioner, there is no requirement to disclose to the client the fact that information is shared with that third party. Accordingly, if you disclose only to nonaffiliated third parties covered by the exceptions described above, the FTC, in section 313.6 and its "Sample Clauses" (in

exceptions described above, the FTC, in section 313.6 and its “Sample Clauses” (in appendix A), states the following language must be placed in the notices: “We do not disclose any nonpublic personal information about our customers or former customers to anyone, except as permitted by law.” If you disclose to nonaffiliated third parties that are not covered by the exceptions, then you are required to list in your notices, by category, the nonexempt third parties (such as insurance agents, retailers or marketers), and the FTC states the following clause should also be added: “We may also disclose nonpublic personal information about you to nonaffiliated third parties as permitted by law.”

The FTC’s rules do, however, limit the extent to which a nonaffiliated third party may use and reuse the information that has been disclosed. Specifically, a nonaffiliated third party may disclose the information only to the financial institution itself, the third party’s affiliates (who are also bound by the same restrictions as the third party) or pursuant to the exceptions outlined above—that is, to obtain a service in connection with the service or the function the outside firm is performing.

Furthermore, the FTC promulgated safeguard rules that require a financial institution, which, again, could be anyone offering financial services, to oversee the third-party provider’s use of the information and ensure compliance with GLBA. This rule (16 CFR section 314.4) requires that institutions develop, implement and maintain an information security program. In doing so, an institution must oversee service providers by taking reasonable steps to select and retain service providers that are capable of maintaining appropriate safeguards for the customer information at issue and requiring service providers by contract to implement and maintain such safeguards. (AICPA/CICA Trust Services Principles and Criteria Framework may be useful as a benchmark when determining the appropriate safeguards for service providers.)

#### **INTERNAL REVENUE CODE**

IRC section 7216 prohibits anyone who is involved in the preparation of tax returns from knowingly or recklessly disclosing or using the tax-related information provided other than in connection with the preparation of such returns. Anyone who violates this provision may be subject to a fine or even imprisonment. The regulations under section 7216 provide an exemption from this law for tax return preparers who disclose taxpayer information to a third party for the purpose of having that third party process the return. Nevertheless, members should make third-party providers to which they have supplied protected client information aware of this requirement. Note there is no requirement in section 7216 or its regulations for a member to inform the client that a third-party provider is being used.

In addition, IRC section 7525 provides a client with a privilege similar to an attorney-client privilege when they make certain tax-related disclosures to, among others, CPAs. Care needs to be taken to assure that a third-party provider does not do anything that adversely affects a client’s rights under this provision.

Because of the requirements of federal law as outlined above, it is important for practitioners to be aware of their continuing obligations to safeguard client data. In this regard, it would be advisable—indeed likely necessary—to perform due diligence before disclosing information to a third-party provider to ensure the provider is

before disclosing information to a third-party provider to ensure the provider is capable of adequately protecting nonpublic information. (As noted earlier, the Code of Professional Conduct imposes similar obligations.) This seems particularly imperative where the provider is located in an unfamiliar location, or where enforcement of privacy laws and the prosecution of those who misappropriate private information may be more difficult. Thus, the contract between the practitioner and the third-party provider should contain appropriate provisions for the protection of consumer privacy.

### THE PRACTITIONER'S DUTY

Whether they derive the regulations from the Code of Professional Conduct, the Internal Revenue Code or the Gramm-Leach-Bliley Act, practitioners and their firms are responsible for maintaining the security and confidentiality of client information. In addition, in performing any service for a client, practitioners must do so with professional competence, with due professional care and in compliance with all provisions of the Code of Professional Conduct. Even after the practitioner is satisfied that a third-party provider is properly structured to ensure continued compliance with all laws and regulations and ethical requirements, a practitioner's duties do not end. Monitoring procedures should be established to ensure the procedures that third-party providers have put into place remain effective.

Practitioners and their firms should consult their own legal advisers for additional guidance on this subject. ■



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